BELLSOUTH SERVICES - DATA BY PRODUCT GROUP
($000)

		1988	1989	1990	1991
A. TOTAL BSSI EQUITY (END OF YEAR)	(JWC-56)	93,845	199,464	179,421	198,365
B. TOTAL BSSI INVENTORY (END OF YEAR)	(JWC-56)	116,440	128,430	89,704	71,475
GENERAL STOCK (EXCLUDING CPE & BSP)					
C. AVERAGE MONTHLY INVENTORY	(JWC-82)	100,607	91,637	78,565	59,306
D. MATERIAL COST OF GOODS SOLD	(JWC-75)		391,028	376,844	223,596
BSSI EUCE OTHER STOCK (PBX, KEY CPE, DOES NOT INCLUDE BSP)					
E. AVERAGE MONTHLY INVENTORY	(JWC-82)		32,559	29,142	12,217
F. MATERIAL COST OF GOODS SOLD	(JWC-75)		[redacted]	[redacted]	[redacted]

BELLSOUTH SERVICES

G. TOTAL BSSI EQUITY AS OF 12-31-88		93,845
CPE TRANSFERS TO BSS FROM ADVANCED SYSTEMS		
H. EQUITY 1-1-89	JWC-65)	56,900
I. LIABILITIES 1-1-89	(JWC-87)	[redacted]
TOTAL ASSETS TRANSFERED		
BSSI EQUITY INFUSIONS		
J. MARCH 1989	(JWC-65)	30,000
K. APRIL 1989	(JWC-65)	20,000
		50,000
TOTAL EQUITY TRANSFERRED TO BCS 1-1-92		
L. "STRONG" RECOMMENDATION LETTER	(JWC-68)	62,600

Figures redacted at Company request.

BSSI NET INCOME ANALYSIS
($000)

	1989	1990	1991 *
A. TOTAL BSSI NET INCOME (JWC-56)	32,502	366	18,945
B. LESS BSP NET INCOME & INTERSTATE REFUND (SURVEILLANCE REPORT)	(26)	(21,181)	(1,295)
C. BSSI NET INCOME FOR SURVEILLANCE REPORTS (C=A-B) EXCLUDING BSP & $5.5M REFUND IN 1990	32,526	21,547	20,240
GENERAL STOCK (EXCLUDING CPE & BSP)			
D. CONTRIBUTION REALIZED AFTER EXPENSES (JWC-75) ASSIGNED BY COMPANY FOR MATERIAL SOLD	34,331	12,782	9,375
E. EFFECTIVE TAX RATE (JWC-81 BSS NOI CALCULATIONS)	33.9%	33.5%	33.4%
F. EFFECTIVE CONTRIBUTION TO NOI (F=D*(1-E))	22,693	8,500	6,244
BSSI EUCE OTHER STOCK (PBX, KEY CPE, DOES NOT INCLUDE BSP)			
G. CONTRIBUTION REALIZED AFTER EXPENSES (JWC-75) ASSIGNED BY COMPANY FOR MATERIAL SOLD	[redacted]	[redacted]	[redacted]
H. EFFECTIVE TAX RATE (JWC-81 BSS NOI CALCULATIONS)	33.9%	33.5%	33.4%
I. EFFECTIVE CONTRIBUTION TO NOI (I=G*(1-H))	[redacted]	[redacted]	[redacted]
J. NOI CONTRIBUTION FROM SERVICES (P=I-L-O)	5,426	11,184	12,692

Figures redacted at Company request.

BSSI RATE OF RETURN ON EQUITY ANALYSIS
TOTAL BSSI
($000)

	EOY 1988	EOY 1988 PLUS TRANSFER & 1/2 INFUSION	EOY 1989	EOY 1990	EOY 1991
A. TOTAL BSSI EQUITY (END OF YEAR) (JWC-56)	93,845	174,745 1/	199,464	179,421	198,365
B. AVERAGE EQUITY ((BOY+EOY)/2)			187,105	189,443	188,893

BSSI EUCE OTHER STOCK (PBX, KEY CPE, DOES NOT INCLUDE BSP)		1989 AVERAGE CPE EQUITY	1990 AVERAGE CPE EQUITY	1991 AVERAGE CPE EQUITY
C. INITIAL CPE EQUITY TRANSFER	(JWC-56)	55,900	55,900	55,900
D. ESTIMATED CPE LIABILITY CONVERSION TO EQUITY		[redacted]	[redacted]	[redacted]
E. PREVIOUS NOI CONVERSION TO EQUITY				
F. ONE HALF NOI CONTRIBUTION	(P.3I)			
G. AVERAGE CPE EQUITY	(G=C+D+E+F)			62,825 2/
H. CPE NOI CONTRIBUTION	(P.3I)	[redacted]	[redacted]	[redacted]
I. CPE RETURN ON EQUITY IN RATE BASE	(I=H/G)	7.6%	3.0%	2.1%

GENERAL STOCK AND SERVICES(EXCLUDING CPE & BSP)		1989	1990	1991
J. AVERAGE NON-CPE EQUITY	(J=B-G)	129,000	128,202	126,068
K. NON-CPE NOI CONTRIBUTION	(K=P.2, L+P)	28,118	19,684	18,935
L. NON-CPE RETURN ON EQUITY		21.8%	15.4%	15.0%

1/ 1/1/89 CPE transfer and 1/2 of the March and April equity infusion.
2/ This is corroborated by the amount of equity transferred to BCS on 1/1/92.
See JWC-68 Company's "strong" recommendation letter.

Figures redacted at Company request.

Affiliate Transactions - BSC Allocator
Preliminary Finding No. 17

1.	Total Retained Costs/Year (RBL 62B, Column F, Lines 7, 10 and 12)		$125,443,146
2.	Total Retained Costs/Month (Line 1 ÷ 12)		10,453,596
3.	November 1991 Allocation per RBL-57 ($000):		
		As Performed	With Retained
	A. UNHQ	$109,558	$101,416 *
	B. SBTT	458,107	458,107
	C. SCBT	323,541	323,541
	D. BSBS	18,863	18,863
	E. RETAINED	-	10,454
	F. TOTAL	$910,069	$912,381
4.	Percent SBT (Line B ÷ Line F)	50.34%	50.21%
	Percent Retained (Line E ÷ Line F)	0.00	1.15%
5.	Total Allocated in 1991 (RBL-62B, Col.B, Line 8)		$19,662,336
6.	Amount which should have been retained (Line 4 x Line 5)		$ 226,117
7.	Reduction in SBT percent (Line 4 difference)		.13%
8.	Reduction in SBT allocation (Line 5 x Line 7)		$ 25,561
9.	Reduction in GA Allocation (Line 8 x .29)		$ 7,413
10.	Reduction in Intrastate GA Allocation (Line 9 x .75)		$ 5,560

* Reduced by amount transferred to BSC from BSE.

BELLSOUTH
TELECOMMUNICATIONS

Thomas L. Hamby
Assistant Vice President
Regulatory

Suite 397
125 Perimeter Center West
Atlanta, Georgia 30346
404 391-2450

August 23, 1994

Mr. Don Craig
Audit Manager
Georgia Public Service Commission
244 Washington Street, S.W.
Atlanta, Georgia 30334-5701

RE: Southern Bell's Responses to the Final Report of Audit Findings to be presented to the Commission

Dear Mr. Craig:

As agreed, we have attached Southern Bell's responses to the above referenced findings which were essentially transmitted to us on August 15, 1994. We are still receiving revisions to these findings as this transmittal package is being prepared. In addition, no summary of the Audit's findings has been received at this time.

Our assumption is that the final findings, as written, will be included in the report that will be filed with the Commission. The findings that were provided, however, are still stamped as DRAFT. If and to the extent the findings are amended, supplemented or edited, the Company reserves the right to conform its response. The Company's ultimate response to the audit also depends somewhat on the use which is made of the audit or further action by the Commission in reliance on the audit or any finding. The Company reserves the right to supplement or amend its responses in the event of such action.

The Company was still receiving revisions to the findings as late as 12:00 noon on the day the responses were to be transmitted. The Company has made a good faith effort to reflect these changes in its responses. However, the Company feels that it is unfair and unreasonable to receive these changes at such a late date. Furthermore, the Company's time to analyze and respond to the audit findings was unreasonably compressed. The Company considers it unfair and unreasonable that it was only provided approximately two weeks to review the audit findings.

In addition, certain of the draft Audit findings contain information which the Company considers, and has identified as, proprietary. As you are aware, access to proprietary information throughout the audit has been provided to you and the Snavely & King auditors subject to the terms and conditions of the protective agreement. We will respond to findings and preliminary reports which contain proprietary material so long as such information will not subsequently be made public, published or shared outside the scope of the protective agreement.

Furthermore, if any page numbers in the auditors' report have been changed prior to the Company's last draft copy, please note that the Company often refers to specific pages in the report and those numbers would need to be changed accordingly.

We appreciate the opportunity to address the audit findings prior to issuance of the final report.

Please feel free to contact me with any questions concerning this matter. A copy of Southern Bell's responses has been sent to Snavely and King on this date by overnight mail.

Sincerely,

Assistant Vice President

Attachment

Copy to: Snavely, King & Associates, Inc.

SUMMARY

Beginning in October, 1992, Southern Bell has cooperated with the Commission Staff and its outside consultants in an audit, supposedly related to affiliated transactions. The Company has expended countless employee-hours in assimilating documents and copies of documents for the auditors' review, providing interviews and explanations of the Company's policies, procedures and systems, and otherwise assisting the auditors. Most recently Company representatives have worked closely with the auditors to refine and correct preliminary findings. Through this process, a number of the more obvious and gratuitous miscalculations, misunderstandings, and erroneous conclusions have been eliminated. Some remain. As the close of the process draws near[1], the Company's overall assessment and reaction to the audit findings can be summed up in with three basic points:

First, the Company is pleased with the inescapable conclusion that it strictly adheres to and applies the rules and regulations of this Commission. In other words, after nearly two years of intense scrutiny by

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[1]To date, Southern Bell has not been provided with a copy of the final report as it is to be presented to the Commission. The findings provided are still in draft form. However, the Company is advised that the findings will not be changed after the Company's final review. If and to the extent that any finding is amended, supplemented or edited, the Company reserves the right to conform its response. The Company's ultimate response to the audit also depends somewhat on the use which is made of the audit or further action by the Commission in reliance on the audit or any finding. The Company reserves the right to supplement or amend its responses in the event of such action.

It should also be noted that as late as 12:00 noon on the day the Company's responses were to be transmitted to the auditors, the auditors were still making changes to their findings. The Company made a good faith effort to reflect these changes in it's responses to the findings.

Staff and consultant auditors involving the review of thousands of pages of documentation, and countless hours of on-site discussions with a large number of Company employees, the auditors identified only 27 scant areas[2] falling into only 5 major categories even worth addressing in the Report. There is a vastly larger number of processes, accounting practices, and types of transactions which received a clean bill of health.[3] This was expected by the Company and should be good news to the Commission.

At the same time -- and this is the second point -- the Company is disappointed in the audit. The Company cooperated from day one, and has taken every reasonable step to help the auditors understand its practices and procedures. Despite these efforts, the auditors have persisted with a

[2]This is not to say that the Company accepts or agrees with the substance of these 27 findings. They are, in fact, seriously flawed. As will be discussed in more detail later in the summary, roughly 20% acknowledge the Company is strictly adhering to this Commission's rules or other mandates; another 20% acknowledge that no error was detected or simply recommend further expensive, time consuming audits anyway, and at least one identifies transactions that actually benefitted Georgia ratepayers. See eg. Finding No. 15, Report at III, p. 84.

[3]In fact, several finding note the proprietary of some of these processes. For example, Finding No. 13 states "[t]he audit verified that Southern Bell's investment accounting process for the equipment transfers [between jurisdictions] and inventory controls are proper and that the depreciation reserve calculation process which is used by the Company follows the affiliated transaction rules." Report at III, p. 72. See also, Finding No. 9, Report at III, p. 48. "It likely that complete reconciliation was effected...in connection with the Company's annual true-up of central office equipment."

number of findings which can only be characterized as remarkable, particularly in light of the ultimate audit objective as stated in the report. While possibly repetitious, that objective bears repeating here. It reads:

> (8) to receive a report of all instances of non-compliance with this COMMISSION's rules concerning transactions with affiliates (FCC - Section 32.27), allocation of costs between regulated services and non-regulated activities (FCC - Section 64.901) and all indications or instances of illegal acts that could result in criminal prosecutions (these may be reported separately).

Report at II, p. 4.

What is astonishing is not the objective. It is plainly stated and makes sense. The astonishing part is that in several findings the auditors recommended "penalizing" the Company in some form or another for strict adherence to the Commission's rules.

Finding No. 2, <u>Tax Allocation</u> is an example. "Rule 32.27(e) requires the use of stand-alone accounting tax calculations for carriers who are parties to consolidated tax returns." Report at III, p. 17. As is correctly pointed out in footnote 1 to the Report, Commission Rule 515-3-1 "<u>requires</u> telephone companies to follow FCC rules governing cost allocations and affiliate transactions." Report at II, p. 3, footnote 1. Even so, the auditors reject the Company's application of stand-alone accounting. Findings No. 3 and 4 are similarly flawed.

Similarly, with regard to Finding No. 1, which discusses the Company's Leveraged Employee Stock Ownership Plan, the auditors do not dispute the Company's claim that its treatment of the dividend deduction for tax purposes is dictated by Generally Accepted Accounting Principles ("GAAP"). Report at III, p. 6. The auditors simply reject GAAP. In Finding No. 5, which attacks the Company's method of accounting for accumulated deferred taxes and unamortized investment tax credits, the auditors acknowledge that there are private letter rulings supporting that methodology.[4] In Finding No. 8, which criticizes the Company's treatment of MemoryCall® as regulated for intrastate reporting purposes, the auditors challenge the view that MemoryCall® is regulated in Georgia. Perhaps if the auditors had been here a year earlier they would have a clearer understanding. Even so, they provide a quote to an open hearing before this Commission in which the Company witness stated in response to a question from Commissioner Rowan and follow-up questions from the Assistant Attorney General:

> It to me is a legal argument of whether it was regulated or non-regulated, and we appealed to the FCC to try to resolve that issue. But from the standpoint of the earnings report, since the Georgia Commission had ruled and that was the rule of the day, then the non-regulated -- previously non-regulated investment expenses for MemoryCall® were included in the intrastate results starting in June of 1991.

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[4]Private letter rulings are not binding authority except for the party seeking the ruling. However, one can scarcely imagine the Internal Revenue Service imposing a diametrically opposed application of the tax code on another party.

Report at III, p. 44.

In roughly 20% of the findings, the auditors acknowledge the authority cited by the Company, but recommend some penalty anyway. In several of these cases, the auditors are urging the Commission to act in flagrant and arbitrary disregard for and in violation of its own rules. Assuming such action would be legally sustainable, which it would not, it would create a policy of absolute uncertainty among regulated utilities which ultimately would work to the detriment of ratepayers.

The third category can only be characterized as disappointment and frustration at the lack of objectivity displayed by the outside consultants. In Finding No. 11, the auditors suggest that somehow Southern Bell prevailed upon AT&T to restructure to shift cost from expense to capital based on the incredible premise, the auditors argued that Southern Bell was able to charge lower rates for its competitive services at the expense of basic ratepayers. This finding is nothing short of absurd. That is what the Company has explained repeatedly and that is what AT&T has explained. On June 14, 1994, AT&T provided to each Commissioner the affidavit of Richard F. Neri. Mr. Neri explained that AT&T's decision to restructure its hardware and software prices was the result of "market research and analysis." Moreover Mr. Neri pointed out that the "1990 price restructure was implemented nationwide, equably effecting all of AT&T's 5ESS[R] Switched System customers. It was not implemented in response to any

[R]5ESS is a registered trademark of AT&T

request by a single customer, including BellSouth Telecommunications Corporation." Key representatives of Southern Bell have explained repeatedly, and in many forms, that the auditors findings are unfounded. Southern Bell employed Deloitte & Touche to conduct an independent analysis of the impact of the price restructuring. This major accounting firm concluded that the auditors findings were totally erroneous. The auditors simply shrug off the overwhelming weight of this evidence and persist on the basis of copies of several slides from an AT&T marketing presentation designed to pique the Company's interest in additional switch purchases. The company believes that this reflects a blatant lack of objectivity.

In Finding No. 14, without any reference or citation to the basis for the statement, the auditors contend that the Company's primary motive for supporting such regulatory reform was to enhance its opportunity to cross-subsidize regulated services and to shift costs from competitive to non-competitive services. Senate Bill 566 did not pass. One wonders why the auditors make this finding at all. Whatever the auditors motives, political commentary and speculation on the Company's or anyone's motives in the legislative process are far removed from the scope of any credible audit. The finding might be appropriate on the editorial pages of a newspaper, but has no place in a formal audit.

In the final analysis, the Company is disappointed with what the audit contains, but at the same time it is pleased with what the audit did not say. There are far more practices, procedures, and transactions that were scrutinized and given a clean bill of health than were the subject of finding in this audit. When the absurd, the speculative, those findings noting compliance with the Commission's rules or other mandates, and those reflecting extreme subjectivity are eliminated, the result is a complementary picture of Southern Bell which indicates no further action is required by the Commission.[5]

[5]Contrary to the auditors' assertion in Finding No. 14 in which the auditors imply a sense of urgency for resolving the audit issues, for the various reasons pointed out in the Company's responses, the findings are seriously flawed and no further action is required.

FINDING/RECOMMENDATION:

The special tax benefits of the Company's Leveraged Employee Stock Ownership Plan should flow to regulated operations.

COMPANY RESPONSE:

The Company does NOT agree that the Commission should adjust Georgia's earnings to include an allocated share of the BellSouth tax savings associated with the dividend payments. The auditors have used a seriously flawed analysis, ignored factual data provided by the Company, and are not cognizant of more recent developments all of which would lead to a different conclusion than that recommended by the auditors.

First, the dividend payments, which result in the tax savings, are made by BellSouth Corporation, on BellSouth Corporation common stock, from equity earnings. The financial accounting employed for the ESOP tax benefit is required by GAAP. For federal tax purposes, BSC is the only entity legally entitled to the tax benefit. The tax savings do not result from expenses charged to subsidiaries, and therefore, they are not allocated to the subsidiaries.

Second, the fundamental concept of any LESOP is based upon growth in stock price and dividends which, accordingly, reduce the cost of the LESOP versus a non-leveraged. This would result in lower expenses for the Company and ratepayers over the LIFE of the plan. However, the audit has focused on a relatively short period of time (1990-1992), while the BellSouth plan covers a 13 year period. The analysis and subsequent decision to adopt the LESOP occurred during 1989 and early 1990, a period of good national economic conditions. Subsequent to the adoption of the plan, the national economy took an unforeseen severe downturn, which adversely affected financial markets, generally, and BellSouth's stock price specifically. The auditors' recommendation ignores factual data which clearly demonstrates that BellSouth's common stock has regained and sustained significant market value well above the earlier period and well in excess of the Trustee's cost per share. In fact, in 1994 the existence of the ESOP has resulted in LOWER costs to Georgia ratepayers. Based on current projections, the stock losses incurred during the recessionary period will be recovered over a very short period of time.

Third, the analysis is defective and, thus inappropriate, as regards several key points based upon a review of the backup workpapers which were provided.

CALCULATION OF 1993-1994 INCREASED COSTS

The calculation of the increased cost for the period of 1993-1994 incorrectly assumes the EXACT same set of circumstances that existed during

COMPANY RESPONSE (Cont'd.):

1990-1992. In fact, actual data for all of 1993 and through August of 1994 is contrary to the auditors' assumptions.

Assumed Stock Loss[1]

The analysis of the assumed stock loss is inappropriate. The stock loss calculation used PROJECTED data for 1993-1994 based on results during 1990-1992. In 1993, BellSouth's stock price rose from $51.75 to $58.00 (10.8%), which was well above the Trustee's cost per share. Using actual 1993 stock prices, there was a $3.3 million gain which would offset the earlier expense increase. Furthermore, if the BellSouth stock increases only 6% in 1994, there would be an additional ESOP gain of $7.1 million. As of 7/31/94, the BSC common stock had sustained an average daily closing share price in 1994 of $60 or more per share with highs approaching $63 per share. (Many independent market analysts continue to place a "buy" recommendation on BSC stock, reflecting continued appreciation of the stock.) The combined gain would more than offset the stock loss of $7.3M shown on Appendix D, page 3, line 10. The auditors' assumption of a continuing stock loss is without foundation.

Interest Expense[1]

The narrow time period (1990-1992) in the audit analysis assumes that interest expense and the shares allocated accrual methodology will yield the same results over the remaining life of the leveraged features. This is contrary to the actual operation of the plan. For example, the auditors have assumed interest expense in the years of 1993 and 1994 remain, on average the same as in the past (Appendix D, page 3, line 8). Since the ESOP debt is an amortizing security, interest expense is high in the early years and declines in the later years as the outstanding principle is reduced. The actual average interest expense for 1993-1994 is less than the average interest expense during 1990-1992. (For example, interest expense was $74.8 million in 1991 and $67.9 million in 1993.) The auditors' assumption that interest expense will remain essentially unchanged is contrary to the actual debt obligation.

[1]The audit report in Appendix D, Page 3, line 16 notes that the auditors, after numerous discussion with the Company, have considered increases in stock price and decreases in loan interest in their calculations. However, the actual impact of these items is significantly higher than what the auditors have included in their calculations, and it would continue to increase in future years.

COMPANY RESPONSE (Cont'd.):

RISK ASSUMPTION

In the reports' Recommendation, the statement is made, "...the local telephone company ("OTC") must assume the risks and costs associated with the [ESOP] loan and value of the stock purchased." This is an incorrect understanding of the ESOP obligation. As set forth in the debt offering for the ESOP, there is no obligation ascribed to Southern Bell or any other subsidiary of BSC. BSC is ultimately and solely the guarantor of the debt obligation.

ADMINISTRATION COSTS

The report makes reference to the administration costs of the LESOP (Appendix D, page 4, Note f) based on information originally provided the Company in prior years. Subsequent to that response the LESOP and BSC modified the treatment of such administrative costs. Effective January 1, 1993, certain administrative costs incurred by BSC were recovered from the trust. In turn, the Trustee began to recover administrative costs of the ESOP from individual plan participants (e.g. employees) using a schedule of annual and transaction fees, as more fully described in the 1993 SEC Form 10-K for the ESOP plans. Consequently, BSC has materially reduced the costs it has incurred in the operations of the plan and those passed down to subsidiaries.

CONCLUSION

In conclusion, the Company disagrees with the audit's finding of the existence of a cross-subsidy, or the need for either a one-time or continuing NOI adjustment to the Georgia Surveillance Report. The tax accounting related to the dividends arises solely because BSC, not SB, common stock is used to provide the matching obligation and because BSC, not SB, dividends are used to service the debt obligation, which is the actual legal obligation of BSC, not SB. (BSC, not SB, advanced the funds to make the first debt service payment to the ESOP. BSC will not recover those funds from the participating subsidiaries until the end of the 13 year leverage period.) As demonstrated in the information provided to the auditors, each participating company bears the direct expenses of the employee benefit plans and shares in the attendant cost reductions. Thus, no cross subsidy exists. Furthermore, the Company disagrees with the assertion that the tax benefit should be assigned to Southern Bell because such assignment would be contrary to GAAP and the current tax code.

COMPANY RESPONSE (Cont'd.):

CONCLUSION

Finally, in proposing the NOI adjustments to Georgia Surveillance Report, the auditors have employed a seriously flawed methodology which results in a distorted projection. Any LESOP is designed and intended to reduce costs over the life of the plan. The wide-spread adoption of the LESOP is a testament to its financial attractiveness. A complete analysis of BSC LESOP's performance to date demonstrates that it is currently doing so. The auditors have used selected, non-representative data upon which it has based the proposed NOI adjustments. Accordingly, the NOI adjustments as proposed are inappropriate.

FINDING/RECOMMENDATION:

The Company has achieved a significant cross-subsidy from its regulated operations and BAPCO to its nonregulated operations as a result of its filing of consolidated tax returns. The cumulative tax savings should be deducted from the Company's rate base.

COMPANY RESPONSE:

The Company thinks this finding is remarkable since the objective of the audit was to find "all instances of non-compliance with the Commission's rules concerning transactions with affiliates (FCC-Section 32.27)" and yet the auditors state that the cause of this Finding is the Company's "strict adherence to FCC Rule 32.27(e)."

Tax expense for Southern Bell is appropriately determined on a stand-alone basis, which as the auditors state is in compliance with Part 32. Moreover, this finding incorrectly asserts that the "stand-alone tax expense calculations enables a cross-subsidy from profitable regulated operations to unprofitable nonregulated operations." In fact, the converse is actually true. If the regulated entity's tax liability has been correctly calculated, and that fact has not been challenged, then to reduce the regulated liability by losses generated by nonregulated operations results in a subsidy to the regulated operations.

The Company believes that any consolidated tax adjustment is inherently unfair and inappropriate since the tax benefits derived from filing a consolidated return are a result of shareholders' investments in unregulated enterprises which are not supported nor insured by the ratepayers. The Commission would be instituting a change in policy for all regulated utilities and not just BellSouth because the adjustment recommended by the auditors would impact all regulated entities that file consolidated returns. In addition, an adjustment to rate base of any past consolidated return benefits would constitute inappropriate ratemaking.

A basic principle of regulation is the separation of regulated utility operations from nonregulated operations. This principle is achieved related to income taxes when the stand-alone concept is applied to the calculation of current income taxes. Under this concept, the tax law is applied on an entity by entity basis. The result is that the current expense for the regulated utility reflects the impact of the activities of the regulated utility and only those activities. In other words, if BellSouth had chosen not to invest in any unregulated operations after divestiture, Southern Bell (and Southern Bell-Georgia) would have recorded

COMPANY RESPONSE (Cont'd.):

the same tax expense for the years 1988 through 1991 as were actually recorded. Even though some unregulated operations may have initial losses, the assertion by the auditors that "the regulated operations subsidize a portion of the initial losses by being charged with overstated taxes" is incorrect. The stand-alone concept results in each company recording its true separate company tax liability. The FCC recognizes the fairness of this concept by requiring stand-alone tax expense calculations under Rule 32.27(e). The Georgia PSC has adopted Part 32.

The auditors also assert that the regulated utility will not share in any of the profits once an unprofitable unregulated company becomes profitable. The Company believes that the principle of regulation should be upheld maintaining the separation of the regulated utility operations from the unregulated operations. Under the Company's current procedures, the regulated operations do not share in either the losses or the gains from the nonregulated operations.

Furthermore, the auditors are incorrect that any benefit from filing a consolidated tax return is permanent. Although such filing allows the group to use a group member's loss in the current year, that member company would have been able to use that loss itself when it became profitable. The auditor's "Example" illustrating a supposed subsidy is flawed in that it fails to reflect the fact that the consolidated return prevented the nonregulated entity from using its own loss in Year 1 to reduce its income tax liability from $3,500 to $0 in Year 2.

In addition to the basic inequity of their position, the impact of $44.7 million which the auditors estimate to be the benefits of consolidation attributed to Georgia are grossly overstated. Profitable unregulated operations have provided substantially all the tax payments necessary to appropriately compensate the unprofitable unregulated operations for the benefits of their tax attributes contributed to the consolidated group. As a result, there is no consolidated benefit to be attributed to Georgia.

It should be clear that the adjustment is simply incorrect, but the Company would note that if the Commission were to make the recommended adjustment, this would constitute an unlawful taking of Southern Bell's property in contravention of the 14th Amendment to the United States Constitution as well as analogous provisions of the Georgia Constitution. In addition, under the federal decisions in Hope and Bluefield, as well as the case authority in Georgia, Southern Bell is entitled to an opportunity to earn a reasonable return on its investments dedicated to the provision of

COMPANY RESPONSE (Cont'd.):

regulated services in this state. Artificially reducing Southern Bell's tax expenses generated by its regulated operations, by considering matters outside the jurisdiction of this Commission, would violate these legal requirements.

Georgia's rates were set based on consistent estimates in accordance with clearly accepted methods of determining tax expense (in terms of tax law, FCC, and Georgia PSC requirements). Any attempt to engage in retroactive ratemaking back to 1984 would be inappropriate and unlawful.

In conclusion, the tax expense as reported on the Georgia surveillance report is the true tax expense incurred by Southern Bell-Georgia; therefore, the Commission should not make any adjustments to Georgia's earnings or rate base.

Southern Bell Telephone & Telegraph Co.
Georgia PSC Staff Audit
Response to Findings
Item No. 3
September 1, 1994

FINDING/RECOMMENDATION:

Income tax expense charged to regulated operations should not be used to subsidize the losses of nonregulated products and services offered by Southern Bell Georgia.

COMPANY RESPONSE:

The tax calculation for Georgia's regulated operations has been made correctly and the auditors do not challenge that calculation. In addition, the auditors do not challenge the calculation for the unregulated operations when the operations generate income. As is typical of this audit, however, the finding asserts that the properly calculated regulated obligation should be offset by losses associated with Southern Bell's unregulated operations. This is another example of the auditors recommending an inconsistent policy with regard to recording tax expense. The auditors only objective appears to be the assignment of all costs to the unregulated operations and all benefits to the regulated operations regardless of which operation generates the benefits.

While the finding asserts that this adjustment should be done in order to avoid subsidizing unregulated operations, the converse is true. If the regulated operation's tax liability has been correctly calculated, then requiring that the properly calculated regulated tax obligation be reduced by losses in the unregulated area, actually results in a subsidy to the regulated operations. Stated more simply, if the regulated operations of Southern Bell generated $1,000 in tax liability, but ratepayers were only required to pay $800 because of losses in the unregulated area, then it is the regulated operations that are receiving a subsidy.

The Company disagrees with this finding and does believe that if the Commission were to make the recommended adjustment, this would constitute an unlawful taking of Southern Bell's property in contravention of the 14th amendment to the United States Constitution as well as analogous provisions of the Georgia Constitution. In addition, under the federal decisions in <u>Hope</u> and <u>Bluefield</u>, as well as the case authority of Georgia, Southern Bell is entitled to an opportunity to earn a reasonable return on its investment dedicated to the provision of regulated services in this state. Artificially reducing Southern Bell's tax expenses generated by its regulated operations, by considering matters outside the jurisdiction of this Commission, would violate these legal requirements.

FINDING/RECOMMENDATION:

The Commission should instruct the Company to match benefits to related costs.

COMPANY RESPONSE:

As was the case in the second finding, the Company thinks this finding is remarkable since the objective of the audit was to find "all instances of non-compliance with the Commission's rules concerning transactions with affiliates (FCC-Section 32.27)" and yet the auditors state that the cause of this finding is the Company's "strict adherence to Part 32."

The auditors have used a "snapshot" approach to make a recommendation contrary to the Commission's rules, while ignoring similar issues that have a different impact. Following the auditor's recommendation would result in a violation of Part 32 and also would result in a policy change affecting all regulated utilities, not just BellSouth.

In 1978, Southern Bell did not recognize a customer's deposit as income for book or tax purposes because this money was eventually returned to the customer. The IRS disagreed with this treatment for tax purposes and argued that customer deposits should be recognized as income when the customer paid it to Southern Bell. In 1983, Southern Bell paid the tax and interest calculated back to 1978. As a result, deferred tax expense was credited and deferred tax liability was debited. The interest expense was excluded from regulation.

In 1990, the IRS conceded this issue to Southern Bell and as a result, in 1991, refunded the taxes (which had been paid in 1983) and paid Southern Bell interest calculated from 1978 to 1991 (which was partially a reimbursement for the interest expense paid in 1983). Southern Bell recorded the interest received from the IRS and excluded it from regulation, in accordance with Part 32, and reversed the debit to the deferred tax liability.

If Southern Bell had not prevailed in this argument with the IRS, the debit to the deferred tax liability would have remained on the books (continuing today at a potentially even higher balance). This outcome would also mean that Southern Bell should have had a debit to the deferred tax liability beginning in 1978 (i.e., under the auditor's reasoning, Southern Bell's rate base would have been UNDERstated from 1978 to 1983). In addition, Southern Bell still would have incurred the interest expense paid in 1983 and excluded it from regulation.

COMPANY RESPONSE (Cont'd.):

Southern Bell does not win every disagreement with the IRS. When Southern Bell does not prevail, audit settlements with the IRS have the result of understating rate base, for a period of time. Therefore, the auditors have singled out this one situation and asked the Commission to make an adjustment to the Company's records without giving similar weight to the situations where Southern Bell's rate base is understated and where Southern Bell is required to exclude interest expense from regulation.

The Company feels that the current treatment of excluding interest income and interest expense from regulation, is in accordance with Part 32, and is fair and appropriate. Therefore, the Company recommends that the Commission make no adjustment to its treatment of interest income. However, if the Commission decides to implement the recommendation of this finding, the Commission would have to apply the same treatment to interest expense which would result in higher expense to the ratepayer.

FINDING/RECOMMENDATION:

Accumulated deferred taxes and unamortized investment tax credits which represent taxes charged to regulated operations should not be transferred to nonregulated operations. Case-by-case burden of proof concerning any IRC violation belongs with the Company.

COMPANY RESPONSE:

The auditors acknowledge in the audit finding that they are aware of previous IRS private letter rulings in which the Government has concluded it is a normalization violation if a public utility flows through unamortized Investment Tax Credits (ITC) to its ratepayers in conjunction with assets which are no longer in the Company's rate base. Nevertheless, in their recommendation the auditors insist that the Company should not transfer unamortized ITCs to nonregulated operations. This issue is not a choice or a decision which is made by the Company. The IRS position applies to all public utility property which is subject to the IRC's normalization provisions, not just that of BST.

Prior to the creation of a separate entity in 1985, the CPE assets attributable to Southern Bell - Georgia's ASI line of business were already segregated from the Company's regulated operations in Southern Bell's books of account and booked on a below-the-line basis. Similarly, the assets which were transferred in 1991 to BellSouth Communications, Inc., had been assigned or apportioned to nonregulated on Southern Bell's books. Thus Southern Bell - Georgia's regulated customers were not charged the tax expense associated with the unamortized ITC on these assets; and accordingly, were not rightfully entitled to the related benefit. The audit report states that the auditors examined the actual journal entry associated with the BCI transfer and noted that the taxes were appropriately allocated to nonregulated. As a result, the Company is unclear what concerns the auditors had with this transaction.

Regarding the 1987 and 1989 asset transfers to BellSouth Services (BSS), the Company continued to amortize the ITC relating to these assets on BSS' books of account. In 1989, the ratepayers began receiving the related tax benefits through BellSouth's policy of dividending BSS' earnings back to Southern Bell. This dividending was obviously a benefit to the ratepayer.

Lastly, the auditor notes that Southern Bell - Georgia retained the accumulated deferred income taxes associated with the 1989 transfer of an airplane to BSS. It should be understood that this transaction was an intercompany sale accounted for in accordance with Internal Revenue Code sections 1501 and 1502, and not an asset transfer.

FINDING/RECOMMENDATION:

The Commission should be cognizant that the Company derives benefits through deferred tax activity in rate case years and non-rate case years.

COMPANY RESPONSE:

The Company thinks this finding is remarkable since the objective of the audit was to find "all instances of non-compliance with the Commission's rules concerning transactions with affiliates (FCC-Section 32.27)" and yet the auditors state this finding "does not identify any violation of GAAP, Part 32, or IRC provisions." The Company records its book transactions, including deferred income tax expense, in accordance with Generally Accepted Accounting Principles (GAAP) and files its tax return in accordance with the Internal Revenue Code (IRC). As a result, this issue is not a choice or decision which is made by the Company. Any change to the treatment of deferred taxes would involve a change in policy which would impact all regulated utilities, not just BellSouth. Therefore, the Company feels this finding has no merit.